No. 2580 3

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

J. W. RAPPLE,

Appellant,

vs.

HARRY A. DUTTON, as Trustee of the Estate of Lennig Engineering Co., Bankrupt,

Appellee.

BRIEF FOR APPELLEE.

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I.

STATEMENT OF THE CASE.

The question presented in this appeal concerns the right of J. W. Rapple who had sold his interest in a partnership, which consisted of himself and E. B. Lennig, to his copartner Lennig, to require the application of a certain alleged partnership asset to the payment of the debt of a partnership creditor, which debt had been reduced to judgment against the partnership and the members thereof.

On the 30th of December, 1910, the Lennig-Rapple Engineering Co., a partnership, consisting of J. W.

Rapple and E. B. Lennig, was dissolved by mutual agreement of the partners. Lennig bought out Rapple's interest, took over the partnership assets and assumed the partnership debts. Lennig paid to Rapple, as consideration for Rapple's interest in the partnership business and assets, $6000 in cash and a promissory note for $2800. (The fact that Lennig paid to Rapple $6000 in cash and the promissory note of $2800 was omitted from the agreed statement of facts by mistake but this fact was found by the referee, is admitted by appellant and is stated by him in the statement of the case contained in appellant's brief at page 2 thereof.) Although as stated, Lennig assumed the partnership debts, there was no agreement that the partnership assets should be used for the purpose of paying partnership debts. There is no suggestion that the partnership nor either of the copartners was at this time insolvent. There is also no suggestion of fraud or bad faith in the transaction. Lennig continued the business as sole owner until August 5, 1911, when he organized the Lennig Engineering Co., a corporation, and transferred to it the assets of the business, receiving as consideration therefor stock in the corporation. The corporation continued the business for about one year thereafter when it was adjudged a bankrupt and the appellee herein is the trustee in bankruptcy of the estate of said corporation.

One of the assets in the hands of the appellee, as such trustee in bankruptcy, is a fund of $783.44

which arose as follows: The partnership had entered into a contract with the City and County of San Francisco to perform certain work on the county jail and this work was partly performed at the time of the dissolution of the partnership, and was continued both by Lennig as an individual and thereafter by the Lennig Engineering Co., a corporation, and was finally taken over and completed by the bonding company which had guaranteed to the City the completion of the contract. The fund in question represents the profit made upon this contract.

The Asbestos Manufacturing and Supply Co. is the judgment creditor of the partnership holding judgment against the partnership and the members thereof. This creditor has filed its claim in the bankruptcy proceedings as a debt against the corporation. Appellant, Rapple, requires that this fund in the hands of the trustee be applied to the payment of the debt of the Asbestos Manufacturing and Supply Co.

II.

NO PARTNER'S LIEN.

Appellant bases his claim upon the retiring partner's lien or equity and argues that the right of a partner to require the application of the partnership property to the discharge of partnership debts persists after dissolution of the partnership. There is no rule in law nor principal of equity that sanc-

tions such a claim under the facts here presented. While the partnership is solvent and a going concern, its creditors have no lien upon nor equity against its assets, and such assets can be transferred free from any lien or equity. There is no more reason why the partnership could not sell its assets free from lien than why a solvent individual could not do so. There is no more reason why the partnership could not sell its assets to Lennig than to a third person. He paid his price therefor and took the full and absolute title.

The parties, it is true, might have contracted that the partnership property should be applied to the payment of the partnership debts but this they did not do and Rapple now calls upon the court to make such a contract for him. Nor is there any equity in Rapple's position which would incline the court in such a direction. The judgment creditor has not asked that this application of the fund be made to the payment of his debt, nor has he joined in Rapple's request. It is Rapple who has sold these assets to Lennig and who has received the price therefor, who alone claims an equity or lien upon them. The parties whose interests are now at stake are no longer Lennig and Rapple, but on the one hand, Rapple, who seeks to have the judgment of the Asbestos Manufacturing and Supply Co. against him satisfied, and on the other hand, the individual creditors of Lennig or of the Lennig Engineering Co., a corporation, who are represented by the appellee, the

trustee in bankruptcy. Rapple makes no offer to return the $6000 in cash and whatever moneys he may have realized upon the promissory note of $2800, and yet these were individual assets of Lennig and were withdrawn from the reach of Lennig's creditors by the bargain from which Rapple now seeks to be relieved.

> "Retiring partners may, effectually, sell not only their firm interests but also the specific property of the partnership to a remaining partner who assumes the debts, even though insolvent, and thus convert firm property into individual property."
>
> *Remington on Bankruptcy,* Second Edition (1915), Section 2269.
>
> "A valid sale of the partnership property by the firm to one or more of its members, or to a new firm in which some of the former partners are members, puts an end to the old partnership title and destroys the lien of the partners thereon, as well as the preference of the old partnership creditors therein over the individual creditors of the purchasing partner."
>
> *30 Cyc.* 545.
>
> "The (partner's) lien is lost by the conversion of the partnership property into the separate property of a partner. Thus, for instance, where one partner buys the interest of his copartner he takes the property discharged of his copartner's right to have the debts paid therefrom."
>
> "Where a retiring partner sells his interest to his copartner and the latter assumes and agrees to pay the debts, the lien on the assets

> is divested, and the personal obligation of the partner is substituted therefor."
>
> *22 Am. & Eng. Enc. Law* (2nd Ed.) p. 133.

The text in both *30 Cyc.* and *22 Am. & Eng. Enc. Law* is supported by a long list of cases cited in the footnote.

> *Bates on Partnership.*
>
> "Sec. 550. The right of a partner to have the assets applied to pay the debts ceases when he parts with his interest in the assets, as where partners convert their joint interests into separate interests. Hence where a partner retires from the firm, selling or assigning his interest to the continuing or remaining partners he loses his equitable right and can no longer apply as partner, for an accounting and receiver. * * *
>
> "Sec. 551. The fact that the continuing partner, or if a third person, who buys the interest and becomes a partner, assumes the debts and agrees with the retiring partner to indemnify or save him harmless or to pay the debts, does not preserve the lien." (Citing many cases.)

In the extended note to *Dean v. Collins,* 9 L. R. A. n. s. 49, a large number of cases is collected and the author says, page 102:

> "The great preponderance of authority holds that the rule that a sale by a partner of his interest in the partnership assets, or a division of the partnership assets between the partners, effects a waiver or surrender of the individual partner's equity, to which creditors are entitled to be subrogated, to have the firm assets applied to the payment of the firm debts; and that the partnership lien to secure such application

thereupon terminates,—is not altered or affected by the fact that the purchase, or the taking, of a share in severalty, is made upon or in consideration of an assumption of partnership debts. Thayer v. Humphreys, 91 Wis. 276, 30 L. R. A. 549, 51 Am. St. Rep. 887, 64 N. W. 1007; Reddington v. Franey, 124 Wis. 590, 102 N. W. 1065; Maquoketa v. Willey, 35 Iowa 329; Griffith v. Buck, 13 Md. 102; Croone v. Bivens, 2 Head 339; Smith v. Edwards, 7 Humph. 106, 46 Am. Dec. 71; Blackwell v. Farmers' & M. Nat. Bank, 97 Tex. 445, 79 S. W. 518.

"In such case property of the partnership ceases to be joint property; and the lien or equity of the retiring partners to make a sale of the property and an application of the proceeds to the joint debts is destroyed. West v. Chasten, 12 Fla. 315; Griffin v. Orman, 9 Fla. 22; Johnson v. Emerick, 70 Mich. 215, 38 N. W. 223; Cory v. Long, 2 Sweeney 491; Baker's Appeal, 21 Pa. 76, 59 Am. Dec. 752; Webster v. Lawson, 73 Wis. 561, 41 N. W. 710."

Lindley on Partnership (1888), Vol. II, page 603.

"The lien may be lost, either by a *bona fide* sale to a third person, or by the retirement of one partner who disposes of his interest to the other, or to a third person, with his copartner's consent, and who takes the assumption of his copartner or of a third person to discharge all the firm debts."

Story on Partnership, 5th Ed., (1859).

"Sec. 358. It has already been suggested that the rights of antecedent creditors of the partnership are in nowise varied by the dissolution of the partnership. It may be added, that, upon the dissolution, it is competent, for the partners, in case of a voluntary dissolution, to

> agree that the joint property of the partnership shall belong to one of them; and if this agreement be *bona fide,* and for a valuable consideration, it will transfer the whole property to such partner, wholly free from the claims of the joint creditors. * * * The reason of this is obvious. While the partnership is solvent, and going on, the creditors have no equity, strictly speaking, against the effects of the partnership. Neither have they any lien on the partnership effects for their debts." * * *

The decisions cited by the foregoing authors show the overwhelming weight of authority to be against the contention of appellant.

The equitable marshalling of assets so as to apply partnership assets to partnership debts after the property has come into *custodiam legis* is a very different thing from interfering with the contracts made by the parties while the partners are solvent and the business is a going concern. This distinction is pointed out in

Sargent v. Blake, 20 A. B. R. 115; 160 Fed. 57 (C. C. A. Mo.):

> "There are two rules of law which at different times apply to the management and disposition of the property of a partnership; first, partners own, and with the consent of each, have the right and power to sell and dispose of the partnership property, to transform it into the individual property of one or more of the partners, to apply it or its proceeds to the payment of their individual debts in preference to those of the partnership, and to make such other honest disposition of it as they deem fit; second, in the administration of the property of a partnership in the courts the creditors

of the partnership have the right to the application of the partnership property to the payment of the partnership debts in preference to the individual debts of the respective partners. The first is a rule of operation, the second a rule of administration. The first governs during the operation of the partnership business and the disposition of the partnership property by the partners, the second operates during the administration of the partnership property after it is brought into the custody of a court. The first rule prevails until by some suit or act the interposition of some court is invoked to administer the partnership property, and until that time the second rule is ineffective. Before the partnership property is placed in *custodia legis* for administration, it is not held in trust for the payment of the partnership creditors in preference to the creditors of the individual partners. * * * It never could have been, it never was, the intention of Congress that these transactions—these transformations of partnership into individual and of individual into partnership property within four months, or within any other time preceding the commencement of bankruptcy proceedings—should either be rescinded or avoided by subsequent adjudications in bankruptcy unless they were actually fraudulent or voidably preferential."

In *Case v. Beauregard,* 99 U. S. 119, 125, the Supreme Court say:

"So, if before the interposition of a court is asked the property has ceased to belong to the partnership, if by a bona fide transfer it has become the several property either of one partner or of a third person, the equities of the partners are extinguished, and consequently the derivative equities of the creditors are at an end. It is therefore always essential to any

> preferential right of the creditors that there shall be property owned by the partnership when the claim for preference is sought to be enforced. Thus in Ex parte Ruffin (6 Ves. 119), where from a partnership of two persons one retired, assigning the partnership property to the other and taking a bond for the value and a covenant of indemnity against debts, it was ruled by Lord Eldon that the joint creditors had no equity attaching upon partnership effects, even remaining in specie. And such has been the rule generally accepted ever since, with the single qualification that the asignment of the retiring partner is not *mala fide.*"

Fitzpatrick v. Flannigan, 106 U. S. 648, follows and quotes *Case v. Beauregard,* supra. To the same effect also is *Huiskamp v. Wagon Company,* 121 U. S. 310.

Counsel cites in support of his argument *Conroy v. Woods,* 13 Cal. 626:

In this case various matters of fraud are charged in the bill, the contest was between individual and firm creditors both attaching within a few days after dissolution and the decision doubtless effected substantial judgments under the facts before the court.

In *Schleicher v. Walker,* 28 Florida 698 (10 So. 33); and in *Thayer v. Humphreys,* 91 Wis. 276 51 A. S. R. 887); the case of *Conroy v. Woods,* supra, is examined, and the courts state that it is in conflict with the weight of authority and they refuse to follow it; both cases holding that if a partner sell out to his copartner, *bona fide,* that the

property conveyed is converted into individual property of the purchaser free from all equities of the seller.

In *Bates on Partnership,* Sec. 562, *Conroy v. Woods,* supra, is cited in support of an exception to the general rule which we have quoted from this author above.

> "Many cases hold that if the firm is insolvent, or on the eve of insolvency, and both partners are also insolvent, a purchase by one partner of the interest of the other in consideration of the former's assumption of the debts is upon a consideration which is of no value whatever, and according to the English and American authorities, no equivalent having been given, the transfer is in effect voluntary and its only effect, if sustained would be to hinder partnership creditors, and hence is deemed ineffectual to convert the joint property into separate property as against the creditors."

The case of *Allen v. Cooley,* 31 S. E. 634, also cited by appellant, presented a case where one partner sold his interest to another under agreement that the debts should be paid by the continuing partner. The complaint alleged that the assets were being wasted, and that the remaining partner had entered into a fraudulent scheme and had fraudulently transferred the assets. The court held that the retiring partner presented a case for equitable relief.

Buchannan v. Sumner, 2 Barb. Ch. 165, is a case of foreclosure of mortgage; and *Shanks v. Klein,*

104 U. S. 18, concerns the rights of creditors on the death of one partner against the partnership assets and neither case is in point.

Homes v. Baker and Hamilton, 160 Fed. 922, holds that a partnership and its members may be adjudicated bankrupts on an act committed by all the members even after a dissolution and this by express provision of statute (Bankruptcy Act, 5A).

In the case of *In re Filmar,* 177 Fed. 170, the claim for priority is pressed by a partnership creditor who from the first refused to accept the continuing partner as a debtor. In this case, the continuing partner was evidently insolvent at the time of dissolution of the copartnership, for within a few weeks thereafter he was adjudged a bankrupt and scheduled no property other than the original partnership property and all of his debts were individual debts excepting that of the contesting creditor.

In *Loveland on Bankruptcy,* 4th Ed. (1912) page 554, vol. I, *In re Filmar,* supra, and *In re Terens,* 175 Fed. 495 (which case is also cited by counsel) are distinguished from the general rule upon the ground of insolvency.

> "A sale by one partner to his copartner, when the firm is insolvent, which if held would operate to apply the property of the retiring partner to the payment of the individual debts of the partner purchasing, is considered fraudulent and the property distributed as firm property. (In re Terrens, 175 Fed. 495, 23 A. B. R. 680; In re Filmar, 177 Fed. 170, 24 A. B. R.

190; In re Worth, 130 Fed. 927, 12 A. B. R. 566; In re Head, 114 Fed. 489, 7 A. B. R. 556; In re Cooke, Fed. Case 3150 (3 Biss 122); Collins v. Hood, Fed. Case 3015 (4 McLean 186). But it is competent for solvent partners to make any arrangements which they think proper with respect to their joint property in the partnership, or the separate property of the partners, and to alter the character of the property so as to convert joint into separate property and vice versa. Such agreement, if made bona fide, will bind the creditors, and in the event of bankruptcy the property will be administered as firm or separate property, according to the character which the partners have placed upon it.''

III.

THE CORPORATION IS A LEGAL ENTITY.

It will be remembered that not Lennig individually, but the Lennig Engineering Co., a corporation, is the bankrupt in these proceedings. Lennig has never been adjudged a bankrupt. Counsel for appellant states (brief, page 9) that this is immaterial; first, because the corporation took with notice; and second, because equity ''perceives the identity between Lennig and his corporation, thus circumventing the fraud upon Rapple which would result if his rights were held divested by the corporation''. These two reasons are inconsistent because the first assumes that the corporation is, and the second that the corporation is not, a legal entity. The fact that the corporation took with knowledge is immaterial. We are not claiming that the corporation is a trans-

feree without notice. We urge that the transfer of the business, its assets and its liabilities, from Lennig to the corporation, effected a material change which alone would distinguish this case from all of those cited by appellant. Lennig is not before the court in these proceedings. His assets are not being here administered. His individual creditors are not before the court, and have no right to participate. The trustee in bankruptcy, the appellee upon this appeal, is not a representative of Lennig's individual creditors, but of a different set of creditors, to wit, those of the corporation. That Lennig may have individual creditors who are not creditors of the corporation goes without saying. Yet these are the persons who are particularly interested in contesting the claim of Rapple.

That the Lennig Engineering Co. is a valid corporation and a distinct legal entity is clear. The agreed statement of facts admits its incorporation. There is no element of fraud suggested in connection with its creation or with the transfer of the engineering business from Lennig to the corporation. The only fact upon which the argument is based is that Lennig owned practically all of the issued stock.

In the leading case of *Salomon v. Salomon*, L. R. App. Cas. 1897, page 22, Lord Halsbury says:

> "My Lords, I find all through the judgment of the Court of Appeal a repetition of the same proposition to which I have already adverted—that the business was the business of Aron Sal-

omon, and that the company is variously described as a myth and a fiction. * * *"

"My Lords, the learned judges appear to me not to have been absolutely certain in their own minds whether to treat the company as a real thing or not. If it was a real thing; if it had a legal existence, and if consequently the law attributed to it certain rights and liabilities in its constitution as a company, it appears to me to follow as a consequence that it is impossible to deny the validity of the transactions into which it has entered."

And Lord Watson says at page 35:

"What is meant by the assertion that the company 'was the mere nominee or agent' of the appellant I cannot gather from the record; and I am not sure that I understand precisely in what sense it was interpreted by the learned judges whose decisions we have to consider."

And Lord Herschell says at page 43:

"The other shareholders, too, are said to have been 'dummies', the nominees of Salomon. But when once it is conceded that they were individual members of the company distinct from Salomon, and sufficiently so to bring into existence in conjunction with him a validly constituted corporation, I am unable to see how the facts to which I have just referred can affect the legal position of the company, or give it rights as against its members which it would not otherwise possess."

And Lord Macnaghten said at page 51:

"The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are man-

> agers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act. * * *"
>
> "It has become the fashion to call companies of this class 'one man companies'. That is a taking nickname, but it does not help one much in the way of argument."

The fact that in these very proceedings the corcorpation has been adjudged a bankrupt is alone conclusive of its distinct legal entity.

IV.

THE FUND NOT A PARTNERSHIP ASSET.

The nature of the asset which is claimed by the retiring partner further distinguishes this case from all of those cited by counsel. The fund here in controversy, it will be remembered, represents the final profit upon a contract which was executed partly by the partnership, partly by Lennig as an individual, partly by the Lennig Engineering Co., a corporation, and partly by the bonding company. The fund thus represents the fruits not only of the partnership's efforts, but also of the labor of Lennig as an individual, and also of the corporation. Such a state of facts presents a very different case from those decisions such as *Conroy v. Woods,* supra, where a certain physical asset of the partnership was fastened upon by attaching creditors of both

the partnership and of the continuing partner. If it could be said that Rapple had an equitable lien upon this fund at all it could extend only to whatever interests the partnership had in the contract and could not, in any event, exceed 40% thereof.

Dated, San Francisco,
May 20, 1915.

Respectfully submitted,

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